Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of:	)	
	)	
Petition of BellSouth Telecommunications, Inc.	)	WC Docket No. 05-342
For Forbearance Under 47 U.S.C. § 160 from	)	
Enforcement of Certain of the Commission's	)	
Cost Assignment Rules	)	

Comments of Verizon[1]

INTRODUCTION

Given the market and technological changes detailed by BellSouth, it is imperative that the Commission assure that carriers are not subject to unnecessary regulatory burdens. In particular, the Commission should immediately extend the separations freeze and confirm that the freeze precludes states from imposing inconsistent separations requirements. In addition, as the states and Commission eliminate economic regulation, the Commission ultimately should eliminate separations requirements altogether, but only if and when it preempts any inconsistent state rules in order to avoid a proliferation of burdensome and unnecessary cost allocation requirements. The Commission also should eliminate archaic rules that artificially inflate the cost assigned to non-regulated operations and affiliates; those rules make no sense in today's market, where all services are subject to competition. Finally, as with separations, the Commission should ensure that inconsistent state transfer pricing rules are preempted as well. Deregulation does not create a regulatory vacuum, but rather represents a binding and preemptive national policy.

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1 The Verizon telephone companies (Verizon) are listed in Attachment A.

ARGUMENT

I. THE COMMISSION SHOULD PROMPTLY EXTEND THE SEPARATIONS FREEZE

A. The Reasons Underlying the Freeze Apply Even More Strongly Today Than They Did When The Freeze Was Adopted.

The Commission should promptly extend the separations freeze on an interim basis pending fundamental separations reform. The Commission instituted the freeze in 2001 in order to "reduce regulatory burdens on carriers during the transition from a regulated monopoly to a deregulated, competitive environment in the local telecommunications marketplace." *Separations Freeze Order*, ¶ 13. The Commission also explained that the freeze was warranted in light of "rapid changes in the telecommunications infrastructure, such as the growth in Internet usage and the increased usage of packet switching" as well as "other new technologies, such as digital subscriber line (DSL) services," *id.* ¶¶ 1, 12, which "may call into question the continued validity of usage-based separations procedures designed for circuit-switched technologies and services." *Id.* ¶ 12 n.32. As BellSouth's Petition demonstrates, all of the factors the Commission considered when initially adopting the separations freeze apply with even greater force today.

For example, the original purpose of the separations rules was "to prevent ILECs from recovering the same costs in both the interstate and intrastate jurisdictions." Petition, at 43. BellSouth points out that all of the states in BellSouth's territory have moved from rate-of-return regulation to price cap regulation, which "no longer rely on cost information for ratemaking purposes." *See* Petition at 23-39.[2] As competition increases and regulation decreases, there is increasingly no justification to continue to impose <u>*any*</u> regulatory accounting burdens on ILECs,

[2] By contrast, several of the states in which Verizon provides local telephone service continue to regulate rates based on Verizon's rate of return. Regardless of the relief granted to BellSouth, Verizon does not seek forbearance from the separations rules for its local telephone companies at this time.

including jurisdictional separations. Until the transition away from economic regulation is fully complete, the Commission should work to minimize the significant administrative burdens associated with the cost allocation rules. Services have become far more competitive, so requiring ILECs to perform detailed separations analyses – while CLECs and other competitors do not have similar burdens – undermines the Commission's goals of achieving competitive neutrality. *Id.*, at 43-45, 72-76. Moreover, networks have become more complex, and no longer break down easily into the cost assignment rules developed decades ago. *Id.*, at 62-65.

For these reasons, US Telecom has urged the Commission to adopt a Notice of Proposed Rulemaking to address jurisdictional separations reform, and to concurrently grant an interim extension of the current separations freeze. *See* United States Telecom Association White Paper, Paving the Way for Separations Reform, CC Docket No. 80-286 (filed Dec. 13, 2005) ("US Telecom White Paper"). As US Telecom explained, the Commission should act promptly in order to ensure the stability and simplification adopted in the initial freeze are not undermined by uncertainty about whether the current freeze will expire on June 30, 2006. *Id.*, at 1 ("With only six months to go until the freeze is set to expire, carriers already are in the untenable position of having to either make considerable investments in an effort to resuscitate their ability to perform separations studies, or sit tight and hope that the Commission ultimately will decide to retain the freeze.").

The Commission must not permit the freeze to expire or otherwise resurrect the "astonishingly detailed methodology," Petition at 43, inherent in the pre-freeze separations process. Under that process, carriers had to perform more than 475 separate studies, and Verizon alone devoted "at least 60 employees and 11 major computer systems … to maintaining the separations data bases and performing separations calculations." Comments of Verizon on Joint

Board Recommended Decision, CC Dkt No. 80-286, at 2 (Sept. 25, 2000). Gearing up to reinstate that process would be a mammoth undertaking, as US Telecom explained in its White Paper (at 2):

> the costs associated with once again performing facility studies would include additional manpower, program updates, and updates to the provisioning databases to ensure the necessary fields are populated to retrieve separations-type information. The programs that were used to prepare facilities results have not been maintained since the inception of the separations freeze and would need to be validated in order determine whether they are even workable at this point. Feeder system field updates and hardware/software system updates could dictate reprogramming of the facility study programs. The people who maintained those programs prior to the freeze are no longer in place, and new staff would have to be hired and trained. Likewise, the expertise to perform full traffic and facility studies no longer exists, and carriers would have to start from close to scratch to revive these study groups. … [T]he separations-related fields that were maintained in the provisioning databases could be in total disrepair, because those fields are not required for normal provisioning of customers.

There is no legitimate basis for requiring carriers to incur this expense and disruption. By maintaining the freeze, the Commission can avoid imposing undue burdens on carriers while considering whether to adopt a more comprehensive reform of its separations rules.

B. The Commission Should Reaffirm That States Cannot Impose Separations Rules That Are Inconsistent With The Freeze.

Carriers cannot be subjected to inconsistent state and federal cost allocation rules. Having to comply with varying state requirements in addition to federal rules governing the same investment and expenses would be unreasonably burdensome, impede competition, and delay or foreclose the introduction of innovative services.

In particular, the Commission should not create or tolerate a situation where the same investment is split between two different jurisdictions in two different ways. Just as the separations rules are intended to assure against double recovery of the same costs in two jurisdictions, they must not permit states to deny recovery of costs that are properly assigned to the intrastate jurisdiction. Accordingly, in conjunction with extending the freeze, the

Commission should reconfirm that states cannot require carriers to perform separations studies or take other actions that are inconsistent with the separations freeze while the freeze is in effect. Some state regulators or regulatory staff have taken the position that Verizon must reallocate major portions of its network investment to the interstate private line category.[3] That position is inconsistent with the *Separations Freeze Order* because it would compel Verizon to conduct investment studies in order to determine which portions of certain types of investment are used exclusively for providing interstate services.

The *Separations Freeze Order* explicitly states that price cap carriers "will not have to perform the analyses necessary to categorize annual investment changes for interstate purposes" and further explains that, "[b]ecause a goal of the freeze is to reduce administrative burdens on carriers . . . any Part 36 requirement to segregate costs recorded in Part 32 accounts into categories, subcategories, or further sub-classifications shall be frozen at their percentage relationship for the calendar year 2000." *Separations Freeze Order*, ¶¶ 14, 22.[4] Although the *Order* notes that categories or portions of categories that had been directly assigned prior to the freeze should continue to be directly assigned, it makes clear that no investment studies are required: "facilities that are utilized *exclusively* for services within the state or interstate jurisdiction are readily identifiable, [so] the continuation of direct assignment of costs [for those

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3 *See Investigation into a Successor Incentive Regulation Plan for Verizon New England, Inc., d/b/a Verizon Vermont*, Dkt No. 6959, *Order* (Vt. Pub. Serv. Bd. Sept. 26, 2005). Similar arguments have been presented in an ongoing docket of the Maine Public Utilities Commission. *See* Direct Testimony of Robert Loube, Ph. D., on behalf of the Office of Public Advocate, Dkt No. 2005-155 (Maine Pub. Util. Comm'n Sept. 26, 2005).

4 Similarly, the Joint Board's *Recommended Decision* regarding the freeze explained that "carriers will not have to perform the analyses necessary to categorize annual investment changes for interstate purposes. The major divisions of separations, such as central office equipment (COE) and [cable and wire facilities (C&WF)] investment will be allocated to the categories and, where appropriate, subcategories for the given year based on the frozen category relationships." *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, Recommended Decision, 15 FCC Rcd. 13160, ¶ 19 (2000) (emphasis added).

categories] will not be a burden." *Id.* ¶ 23 (emphasis added). In contrast, if plant is used for both interstate and intrastate purposes, the categories, sub-categories, and subclassifications containing that plant, and the allocation of those categories, subcategories, and subclassifications, remains frozen at their 2000 levels.

The Commission should clarify the broad scope of the freeze, in order to prevent states from demanding the reclassification of investment from intrastate to interstate. Not only would such reallocation effectively impose the types of studies and burdens that the freeze was intended to eliminate, but it would result in a state being able to reclassify as "interstate" investment that, under the Commission's rules, must be considered intrastate. Permitting states to engage in such reallocation would undermine not only the freeze, but the entire concept of a unified national approach to jurisdictional separations. *See Crockett Tel. Co. v. FCC*, 963 F.2d 1564, 1567 (D.C. Cir. 1992) ("Although each state has great freedom to regulate intrastate rates, once the FCC has applied its jurisdictional separation, that part of the cost base deemed to be interstate is outside the jurisdictional reach of the state regulatory agency."), *id.* at 1573 ("when the Commission has prescribed an applicable separation methodology, states are not free to ignore it"); *see also Hawaiian Tel. Co. v. Public Utilities Commission of Hawaii*, 827 F.2d 1264, 1275-76 (9th Cir. 1987), *cert. denied*, 487 U.S. 1218 (1988) (finding a state ratemaking methodology to be inconsistent with and thus "necessarily preempted" by federal separations methodology).

C. The Commission Ultimately Should Eliminate Separations, But Must Concurrently Preempt Any Inconsistent State Requirements

Ultimately, the Commission should eliminate separations requirements altogether. In a market where all services – interstate, intrastate, wireline, wireless, local, long distance, basic, and enhanced – are competitively disciplined, regulatory cost allocation requirements such as the separations rules are not only unnecessary to protect ratepayers, but destructive of true competition.

The Commission should only eliminate the separations rules, however, if it concurrently preempts any state rules determining allocation of costs between the federal and state jurisdictions. Without such preemption, the benefits of forbearance at the federal level would be lost and carriers would be subject to dozens of different state separations regimes, with far greater regulatory burden than the current unitary systems.[5]

Under longstanding preemption principles, such inconsistent state rules cannot be permitted. First, Section 10(e) expressly prohibits the states from enforcing federal rules from which the Commission has forborne. 47 U.S.C. § 160(e). Permitting state regulation that is similar to the federal regulation (though perhaps not sharing every detail) would effectively violate that provision and thus be prohibited. *See, e.g., Richmond Power and Light of City of Richmond, Ind. v. FERC*, 574 F.2d 610, 620 (D.C. Cir. 1978) ("What the Commission is prohibited from doing directly it may not achieve by indirection."); *Kinney v. Weaver*, 111 F.Supp.2d 831, 840 (E.D.Tex. 2000) ("[N]umerous cases have held that governmental entities cannot do indirectly that which they cannot do directly."); *Littell v. Udall*, 242 F.Supp. 635, 640 (D.D.C. 1965) ("It would be wholly unrealistic for this Court to accept the Secretary's interpretation of this statute so as to permit him to do indirectly what he cannot do directly.").

Moreover, any state regulation of separations, whether or not similar to the foreborne federal rule, would effectively negate the Commission's judgment that forbearance serves the public interest. Not only would regulation continue, notwithstanding the Commission's

[5] This approach would not violate Section 2(b), 47 U.S.C. § 152(b). States could still regulate intrastate rates in accordance with their chosen regulatory regime (*e.g.*, price caps or rate base); they just could not require a specific allocation of costs between the interstate and intrastate jurisdictions.

judgment that regulation is no longer necessary (or even harmful), but the situation would be even worse than before the Commission granted forbearance. For these reasons, any inconsistent state cost allocation rules must be preempted as upsetting the policy balance wrought by the Commission using its forbearance authority. See *Buckman Co. v. Plaintiffs' Legal Comm.,* 531 U.S. 341, 348 (2001) (finding obstacle preemption where "somewhat delicate balance of statutory objectives" could "be skewed by allowing" state-law claims); *Geier v. American Honda Motor Co.*, 529 U.S. 861, 881 (2000) (a rule of state tort law that imposed a duty contrary to the "mix" of options permitted by federal regulations is conflict-preempted); *Edgar v. MITE Corp.*, 457 U.S. 624, 634 (1982) (finding obstacle preemption where state law "upset the careful balance struck by Congress").[6]

II. THE GROWTH OF COMPETITION UNDERMINES ANY NEED FOR DETAILED AFFILIATE TRANSACTION RULES.

As BellSouth explains in great detail, the rule governing valuations of services and assets transferred between regulated and non-regulated affiliates (§ 32.27), and the Cost Allocation Manual and independent audit requirements, to the extent they relate to the affiliate transaction rule (§§ 64.903, 64.904, and 32.9000), serve no continuing purpose in assuring just and reasonable rates and protecting ratepayers. To the contrary, these rules "represent a formidable obstacle to meeting the demands of the evolving marketplace and giving consumers the innovative products and services they desire." Petition at 32.

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[6] Thus, this is not a case where either the policy adopted by the Commission is outside its authority or the impacts of state regulation could be limited to the intrastate sphere and thus not infringe on the Commission's valid federal policy. *Cf. Louisiana Pub. Serv. Comm. v. FCC*, 476 U.S. 355 (1986). The Commission has unquestioned authority to adopt binding separations rules. 47 U.S.C. §§ 221(c), 410(c); *Crockett Tel. Co.*, *supra.* Moreover, state rules allocating costs between the state and federal jurisdictions cannot be limited in their impact to the intrastate jurisdiction. Rather, once the Commission has decided that a certain portion of costs should be allocated to the interstate jurisdiction – or that costs need no longer be separated at all – any such state rule inevitably would interfere with that decision. *See Louisiana PSC*, 476 U.S. at 375 n.4.

These rules are burdensome and often inject months of delay into the development and deployment of new services. Customers increasingly expect innovative bundles of regulated and non-regulated services, which may include inputs from multiple affiliates. The affiliate transaction rules add to the complexity of designing these offerings and distort purchasing decisions, by requiring needless and resource-intensive cost allocation exercises. For example, even where there is a clear market price for a service that is transferred from one affiliate to another, that price cannot automatically be used for regulated affiliate transfer pricing. Rather, transfers of services from a non-regulated affiliate to a regulated affiliate must be priced at the higher of cost or market value, and transfers in the other direction must be priced at the lower of cost or fair market value. 47 C.F.R. § 32.27(b), (c) (net book cost is used for assets and the tariffed rate or fully distributed cost for services).

Even if these requirements didn't make it harder for LECs to compete, which they do, they are unnecessary in the current market environment. As the Commission has long recognized, robust competition such as that typifying all segments of today's communications industry assures that rates will be just, reasonable, and nondiscriminatory. *See, e.g.*, *Implementation of Sections 3(n) and 332 of the Communications Act*, *Second Report and Order*, 9 FCC Rcd 1411, ¶ 174 (1994) ("[c]ompetition, along with the impending advent of additional competitors, leads to reasonable rates."), *id.* ¶ 173 ("in a competitive market, market forces are generally sufficient to ensure the lawfulness of rate levels, rate structures, and terms and conditions of service …."); *see also Policy and Rules Concerning the Interstate, Interexchange Marketplace*, *I*, 11 FCC Rcd 20730, ¶ 42 (1996); *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities*, First Report and Order, 85 F.C.C.2d 1, ¶ 88 (1980) ("firms lacking market power simply cannot rationally price their services in ways which, or impose terms and conditions which, would contravene Section 201(b) and 202(a) of the Act"). In today's market, competition from wireless carriers, cable companies, VoIP providers, CLECs and other new entrants, constrains the rates that incumbent local exchange carriers can charge for their services. Perpetuating superfluous and burdensome cost allocation and inter-affiliate transaction rules in this environment undermines competition and disserves consumers. Moreover, once the Commission has forborne from these rules, it must preempt states from establishing their own regulations governing affiliate transactions, for the reasons discussed in Section I.C above.

CONCLUSION

For the foregoing reasons, the Commission should extend the separations freeze on an interim basis pending fundamental separations reform, reaffirm that states cannot impose inconsistent cost allocation rules on carriers (including but not limited to separations rules that are inconsistent with the separations freeze), and move toward eliminating federal rules governing separations and inter-affiliate transfer pricing while concurrently preempting any inconsistent state requirements.

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THE VERIZON TELEPHONE COMPANIES

The Verizon telephone companies are the local exchange carriers affiliated with Verizon Communications Inc. These are:

Contel of the South, Inc. d/b/a Verizon Mid-States
GTE Southwest Incorporated d/b/a Verizon Southwest
Verizon California Inc.
Verizon Delaware Inc.
Verizon Florida Inc.
Verizon Maryland Inc.
Verizon New England Inc.
Verizon New Jersey Inc.
Verizon New York Inc.
Verizon North Inc.
Verizon Northwest Inc.
Verizon Pennsylvania Inc.
Verizon South Inc.
Verizon Virginia Inc.
Verizon Washington, DC Inc.
Verizon West Coast Inc.
Verizon West Virginia Inc.